TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING 02-20

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

The application of the Tennessee sales and use tax to an Internet technology company engaged in the business of developing, maintaining, and hosting a web site application software service.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

(A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
(B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
(C) The applicable law must not have been changed or amended;
(D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
(E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[THE TAXPAYER] is a [CITY, TENNESSEE] based Internet technology company engaged in the business of developing, maintaining, and hosting a web site application software service. Web site application software is designed to enable advanced functions on a web site, resulting in greater interactivity between the viewer and the web site. More specifically, this software allows web site viewers to send data to the web site, and also manages the data once it is received. Examples of web site application software are common and include online polls, shopping carts, discussion boards, and feedback forms. Taxpayer maintains this software on application server machines which it owns and operates. These machines are located in Tennessee. Taxpayer does not provide its clients with access to the Internet.

Taxpayer's clients are those that own or manage one or more existing web sites, and wish to add advanced applications such as a poll or discussion board. Generally, transactions between Taxpayer and its clients occur entirely online. Clients access Taxpayer's web site applications by visiting Taxpayer's web site. Once there, clients select which application or applications they wish to make use of, then configure various aspects of how the application software will display information by selecting a color scheme, font, and other items. Finally, the client makes a modification to his or her web site files, which causes a link to be made from the client's web site to Taxpayer's web site application software. The link is not visible to viewers of the client's web site. Once this process is complete, Taxpayer's computers begin to intercept, process, store, and ultimately output information back to the client's web site.[1]

Generally, clients of Taxpayer purchase the functionality and output of software owned by the company for a defined period of time, but do not gain rights to the software itself. In such cases the software remains on Taxpayer's servers; it is never installed on, or transferred to, the client's computer. Taxpayer grants a license to each client allowing the client to use the enabling features of Taxpayer's hardware and software. Such licenses can be on a daily, monthly, or yearly basis.

Some clients, such as professional web site developers, actually purchase software from Taxpayer. These clients then use the software in the creation of web sites for their own clientele. Web site developers do not simply resell Taxpayer's service.

QUESTIONS

1. Whether the fees generated by the web site application software service are subject to Tennessee sales tax?

2. If the licensing fees are taxable, whether Tennessee sales tax should be charged to Taxpayer's clients outside Tennessee?

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[1] For example, in the case of a web poll, Taxpayer's software and hardware intercept votes, tally the results, store the results in a database, then output the results as dynamic statistics and graphics that are embedded in the client's existing web page.

3. Whether Taxpayer should accept a resale certificate from a web site developer who purchases software from Taxpayer, and then uses the software in the development of a web site for a third party?

RULINGS

1. Generally, the fees generated by the web site application software service are not subject to the Tennessee sales or use taxes. In the case of web site developers, however, a sale of software occurs, requiring Taxpayer to collect and remit sales tax.

2. Where title to, or possession of, the software is delivered to the nonresident client in Tennessee, Taxpayer should collect and remit sales tax.

3. Taxpayer may accept a resale certificate from a web site developer, so long as Taxpayer exercises ordinary care in determining whether the software is for resale by the purchaser.

ANALYSIS

1. The sale of customized or packaged computer software, as well as the modification of existing software, is subject to sales and use tax. Tenn. Code Ann. § 67-6-102(24)(B); University Computing Company v. Olsen, 677 S.W.2d 445 (Tenn. 1984); Creasy Systems Consultants, Inc. v. Olsen, 716 S.W.2d 35 (Tenn. 1986). The term "sale" is defined to include "[the] *transfer* of customized or packaged computer software, which is defined to mean, information and directions loaded into a computer which dictate different functions to be performed by the computer whether contained on tapes, discs, cards, or other device or material. For such purpose, computer software shall be considered tangible personal property; however, the fabrication of software by a person for such person's own use or consumption shall not be considered a taxable 'use'. . ." Tenn. Code Ann. § 67-6-102(25)(B) (emphasis supplied).

Here, Taxpayer maintains its software on application server machines which it owns and operates. Except for professional web site developers, clients of Taxpayer purchase the functionality and output of software owned by the company for a defined period of time, but do not gain rights to the software itself. For most clients, the software remains on Taxpayer's servers; it is never installed on, or transferred to, the client's computer by any means, including electronic. Thus, except in the case of web site developers, because title and possession of the software always reside with the Taxpayer, there is no transfer for purposes of Tenn. Code Ann. § 67-6-102(25)(B). Because there is no transfer of title or possession, there is no sale and thus no sales tax.

Some clients, such as professional web site developers, actually purchase software from Taxpayer, however. These clients then use the software in the creation of web sites for their own clientele. Web site developers do not simply resell Taxpayer's service.

Thus, in the case of clients who actually purchase software, including web site developers, Taxpayer must collect and remit sales tax.

For clients other than web site developers, Taxpayer's business is a service. Certain services are taxable as retail sales. Tenn. Code Ann. §§ 67-6-205 and 67-6-102(24)(A), (F). The services taxed include, but are not limited to, repair work, laundry and dry cleaning, parking or storing cars, and telephone service. Here, Taxpayer provides a web site applications hosting service. This service is not included in the list of specifically taxable services. Tenn. Code Ann. § 67-6-102(24)(F). Therefore, the provision of a web site applications hosting service is not a taxable service.

2. Next, Taxpayer asks whether Tennessee sales tax should be charged to Taxpayer's clients outside Tennessee. Generally, nonresident purchasers of tangible personal property in Tennessee must pay sales tax if title to, or possession of, the property is delivered to the nonresident purchaser in Tennessee. *See generally* Tenn. Code Ann. § 67-6-102(25)(A) and TENN. COMP.R. & REGS. 1320-5-1-.29. Further, it is immaterial that the property will later be transported out of state. TENN. COMP. R. & REGS. 1320-5-1-.29. Relying on the analysis set out above, Taxpayer makes sales of computer software to web site developers. Thus, where title to, or possession of, the software is delivered to the nonresident client in Tennessee, Taxpayer should collect and remit sales tax.

3. Lastly, Taxpayer asks whether it should accept a resale certificate from a web site developer who purchases software from Taxpayer, and then uses the software in the development of a web site for a third party. As stated above, computer software is tangible personal property for purposes of the sales and use tax. The retail sale of tangible personal property is a taxable privilege in Tennessee. Tenn. Code Ann. § 67-6-201(1). A "retail sale" is defined to include "a taxable sale of tangible personal property or specifically taxable services to a consumer or to any person for any purpose *other than for resale*." Tenn. Code Ann. § 67-6-102(24)(A) (emphasis supplied). When a resale is contemplated, then:

> (1) [d]ealers shall require certificates of resale for all tangible personal property sold or services rendered in this State, for the purpose of resale, and such certificates must be available at the establishment of the dealer for ready inspection and comparison with the deductions claimed on monthly Sales and Use Tax returns. A dealer duly registered under the provisions of the Sales Tax Act and continually engaged in the business of selling tangible personal property or taxable services at retail may present evidence to his wholesaler or supplier as to his registration as a retailer, and shall not be required to execute additional certificates of resale for individual purchases as long as there is no change in the character of his operation, and the purchases are of tangible personal property or taxable services of a sort usually purchased for resale.

(2) All sales for resale which are not supported by resale certificates properly executed shall be deemed retail sales, and the dealer held liable for the tax unless the same comes within the exception mentioned as a part of paragraph (1) of this rule.
(3) Certificates of resale may not be used to obtain tangible personal property or taxable services to be used by the purchaser, and not for resale; such use shall be grounds for the Commissioner to revoke the registration certificate of the dealer wrongfully making use of such certificate of resale. In addition to this penalty it is a misdemeanor to misuse the certificate of registration and resale certificates for the purpose of obtaining tangible personal property or taxable services without the payment of the Sales or Use Tax when it is due.
(4) If a wholesaler or dealer sells tangible personal property or taxable services free of the Sales or use Tax on a certificate or resale when he knows, or should know in the use of ordinary care, that the property or service which he is selling is not for resale by the purchaser, but is for the purchaser's own use or consumption in his business or otherwise, the registration certificate of the wholesaler may be revoked by proper action by the Commissioner, and he shall be liable for the tax.

TENN. COMP. R. & REGS. 1320-5-1-.68.

Based on the foregoing rules, Taxpayer may accept a resale certificate on sales of its software, so long as it uses ordinary care in determining whether the software is for resale by the purchaser. Generally, if a web site developer resells the software to a third party, or if the software is sold as a component part of a completed web site, then Taxpayer may accept a resale certificate. If, however, the web site developer merely uses the software to create a web site, or if the web site developer intends to use the software in the same way the Taxpayer is using it, then Taxpayer's sale of software to the developer is taxable, and a resale certificate may not be used.

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APPROVED: Ruth E. Johnson
Commissioner

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